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USAID Experience With the Provision of Business Development Services in the Europe & Eurasia (E&E) Region

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FOREWARD

This paper was prepared for Steve Silcox and Donna Nails of the Business Development Division at USAID's field office in Kyiv, Ukraine as background information in support of an evaluation of the Mission's business incubator program in Kyiv, Kharkiv, and Lviv. The evaluation report of the incubator program should be available in late 1999 or early 2000.

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I. INTRODUCTION

Private sector development, particularly the formation and growth of small- and medium-sized enterprises (SMEs) in the transition economies of Europe and Eurasia (E&E), is one of USAID's primary objectives in this region. SMEs can be vital stimulants to economic growth because they provide income and employment, assist in the development of the private sector, and make the economy more attractive to potential investors. In order to promote enterprise development in this region, USAID has funded a number of projects that provide services to SMEs. The purpose of such services is to provide both financial and technical assistance. SMEs need access to financing, whether it originates from seed capital or venture capital, or is provided through loans and grants. Managers and owners of these enterprises also need appropriate managerial and technical advice to develop the business skills and experience necessary to operate their businesses effectively. Specifically, managers and owners of SMEs need assistance with business planning, marketing, product design, quality control, and accounting, as well as access to business information.

USAID-funded enterprise development projects have offered a variety of programs that provide support services to new businesses. These services include training, consulting, business information, and access to credit and finance. Enterprise funds, business support centers (BSCs), and business incubators are three mechanisms for delivering these types of services, although it should be noted that enterprise funds, by definition, differ from BSCs and business incubators in terms of level of capitalization, type of clientele, and range of services provided. Enterprise funds were created to provide mostly financial services to businesses, particularly large enterprises, while BSCs and business incubators typically focus on the provision of non-financial services to SMEs. Nevertheless, a section on enterprise funds has been included in this paper because some of the funds have provided non-financial services and loans to SMEs, and enterprise funds are important instruments for spurring enterprise development. Additionally, USAID has also provided assistance to enterprises that require restructuring services, although most enterprises in the E&E region that require restructuring are large, formerly state-owned enterprises (SOEs) that do not need the same kind of support that new SMEs need. Hence, USAID-funded enterprise restructuring projects will not be discussed in detail here. Instead, the purpose of this paper is to evaluate the delivery of business development services to SMEs through USAID-funded projects.

These service providers—enterprise funds, BSCs, and business incubators—have worked well in certain countries, while not so well in others. Overall, their performance has produced mixed results. The enterprise fund in Poland has been more successful than the funds in other E&E countries at disbursing small loans, attracting outside investment, and developing the financial sector. Some of the BSCs in Moldova and Ukraine have been hindered by the lack of staff skilled in Western business practices and a policy environment difficult for SMEs to operate in. At the same time, however, some of the BSCs in Russia have been effective at creating jobs and assisting in new business formation. Incubator programs in Russia and Ukraine have also witnessed mixed results. Although some have been effective at leveraging funds and providing business training, the experience of USAID/Russia, for instance, reveals that incubators are not always as effective in creating and sustaining enterprises and jobs as are other business support institutions.

The first section of this paper details some of the trends and observations gleaned from USAID experience with enterprise development in the E&E region and summarizes the E&E Bureau's enterprise development strategy. The second section discusses the services USAID-funded business development service providers offer to enterprises, including training, consulting, business information, and access to credit and finance. This section also examines the delivery of such services through enterprise funds, BSCs, and business incubators. The conclusion provides the lessons learned from USAID-funded business support projects in the E&E region.

II. USAID EXPERIENCE WITH ENTERPRISE DEVELOPMENT IN THE E&E REGION

Trends and Observations

USAID has been working in SME development in the E&E region for approximately 10 years. Some of the major trends and observations thus far are as follows (Silcox et al. 1997; Webster et al. 1999; Thomas 1998):

- Lack of progress in the economic and political reforms needed to create a competitive marketplace is a major obstacle to SME growth and development.
- Enforcement of hard budget constraints is a necessity for enterprises to succeed; government subsidies to enterprises need to decrease.
- More flexibility in SME development programs is necessary to adapt to changing political and economic conditions.
- SMEs lack a strong collective voice in promoting reforms.
- Enhanced local capacity building is needed to train local institutions to provide services (e.g., technical assistance, financial services) for SMEs.
- Increased attention to the development of financial services for SMEs is needed.
- Full cost-recovery is a desired objective of business development projects, but it may be unrealistic because these projects may not be able to recover all of their costs from client fees and still serve SME development at the same time.
- There exists continued public uncertainty over the benefits of a market economy and exactly what it entails.

E&E Enterprise Development Strategy

As a result of these trends and observations, the goal of E&E's enterprise development strategy is to accelerate the creation of well-functioning markets where laws and regulations are conducive to the efficient functioning of SMEs (Webster et al. 1999). Priority is given to the development of micro-, small-, and medium-sized enterprises (MSMEs) because of their ability to create jobs, provide income, and stimulate growth. This strategy focuses first on business formation, then market emergence, and lastly, the formation of a well-functioning, regulated, and competitive marketplace. The first stage of enterprise development—business formation—is where this paper is primarily focused, although the creation of a competitive market environment is equally important because it seriously impacts the ability of businesses to form and develop.

The USAID Mission in Ukraine, for example, has focused its efforts on creating the enabling environment necessary for SMEs to develop. Particular efforts to create this environment include building support for business associations to promote legal and regulatory reform, providing services to government policymakers, and increasing public awareness of the benefits of private sector development (USAID 1999). Additionally, the Mission supports SMEs through the provision of business development services and financial assistance. The next section discusses these services and the organizations that provide these services in more detail.

III. BUSINESS DEVELOPMENT SERVICES FOR SMALL- AND MEDIUM-SIZED ENTERPRISES

Through enterprise funds, BSCs, and business incubators, USAID provides a variety of business development services that are usually unavailable and/or unaffordable in the marketplace. These services include training, consulting, business information, and access to credit and finance. Typical training offered by business development service providers includes courses on business management, business skills development, sales, negotiations, time management, and starting a new business. Consulting and advisory services usually include assistance with business registration, business planning, and market research. Business information services usually entail access to databases that contain information on SME legislation and key information on potential foreign partners for those clients interested in establishing joint ventures (Lee 1999). Lastly, many business development service providers also disburse loans and/or grants.

USAID also funds several projects focused on enterprise restructuring, which, except for the case of the Slovak Business and Banking Advisory Center (SBBAC), will not be discussed in detail here because they do not deal directly with new enterprise formation. Furthermore, although the focus of this paper is on the business development services provided to SMEs, USAID also funds projects in the E&E region that promote microenterprise development and business support services for the microenterprise sector.[1] Before proceeding, it is important to note that several of the resources consulted for this paper lack hard data relating to the impact of the services provided. Nevertheless, some qualitative generalizations can be made regarding the effectiveness of the organizations providing the services and the impact of the services on the organizations' clientele.

Enterprise Funds

Enterprise funds were established in 1990 by the Support for East European Democracy (SEED) Act to support economic transformation in Central and Eastern Europe (GAO 1999). Although USAID had oversight of the funds, they were created as independent, nonprofit organizations modeled after venture capital management companies with the goal of promoting private sector development and the provision of finance and technical assistance to SMEs as well as larger firms. The funds were first established in Hungary and Poland and then later in other E&E

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[1] For example, in Russia, Opportunity International received USAID funding to implement a project promoting microenterprise development through the creation of an alliance of 10–15 NGOs serving the microenterprise sector. This alliance led to the establishment of a regional training center that provides seminars, networking opportunities, and information distribution. For further information, see Opportunity International 1996. Opportunity International has also been provided with a grant to establish a microenterprise development agency in Macedonia to provide credit, enterprise development training, and networking opportunities. For further information on this project, see USAID 1995.

countries as well as one in Southern Africa. In sum, eleven enterprise funds are now in operation. The purpose of these funds is to invest in local enterprises, give out micro and small business loans, disburse technical assistance grants, provide business education and training, and raise private capital.

While the original funds—particularly the one in Poland—have been relatively successful in comparison to the newer funds, performance among and impact of the funds has varied from country to country due to differences in macroeconomic and political stability, legal and regulatory frameworks, and fund management. The newer funds—those in the Baltics, Central Asia, Russia, Southern Africa, etc.—have been making investments at a much slower pace than the first funds due to a less favorable economic climate and stiffer competition from private investors (Fox 1999). In terms of impact on employment, the funds have invested in companies that collectively employ approximately 80,000 people, the majority of which work for SMEs. The funds have also broadened access to capital for businesses, including investments of more than U.S. $800 million, in which the majority of the investments are made in SMEs (GAO 1999). Cumulatively, the funds have been able to attract outside private investment, totaling over U.S. $740 million (GAO 1999). Most of this investment has been generated by the funds in Poland and Russia. The funds have also made more than 3,300 loans and investments, most of which are through the micro- and small-enterprise loan programs.

Poland

The most successful fund to date has been the Polish-American Enterprise Fund (PAEF). Established in 1990, the PAEF was initially the largest of the European enterprise funds, until the incorporation of the fund in Russia in 1993 at U.S. $440 million, with obligated funds of approximately U.S. $260 million. One of the main reasons PAEF has been so successful is due in large part to receiving an initial capitalization nearly three times the amount of the other funds. The funds in Hungary, Czech and Slovak Republics, and Bulgaria had initial capitalizations of only U.S. $70 million, U.S. $65 million, and U.S. $55 million, respectively. Some indicators of PAEF's success, relative to its counterparts, are that it has disbursed small loans to enterprises that employ approximately 50,000 people, attracted approximately U.S. $320 million in additional investment from the private sector, has made grants to management institutes to provide business courses and MBA-type degree programs, and has made significant contributions in developing the financial sector. PAEF has held a majority ownership in First Polish-American Bank of Krakow and is a major investor in two other financial institutions. To carry out its investment and technical assistance activities, the PAEF has established several subsidiaries. The Enterprise Credit Corporation is one such subsidiary and it is tasked with making loans to new small businesses. Other subsidiaries include a management company, a mortgage banking company, and a venture capital fund. PAEF uses technical assistance funding to train bankers, support business clubs, and create microenterprise lending programs. PAEF is expected to sell its assets and end operations by 2001.

Bulgaria

The Bulgarian-American Enterprise Fund (BAEF), established in 1992, although not a failure, has had less of an impact than PAEF due to several factors. First, BAEF was only capitalized at U.S. $55 million, significantly less than that of PAEF. Second, BAEF's first two large investments failed, resulting in total losses of approximately U.S. $2 million. Third, the political and economic climate has not been as supportive of private sector development as that in Poland. For instance, throughout most of BAEF's program, the Bulgarian economy has witnessed high rates of inflation, a devalued currency, lack of foreign direct investment, near collapse of the banking sector, slow process of privatization of SOEs, and political instability. As a result of this difficult environment, BAEF initially focused heavily on lending rather than investing (Reintsma and Tarnoff 1996). At present, however, through its various programs, BAEF has significant investment activities. In the agriculture, agribusiness, and food processing sectors, BAEF makes debt and equity investments of up to U.S. $2 million for joint ventures and businesses needing expansion capital (BAEF 1999a). Additionally, BAEF is making significant investments in hotels, construction, home mortgages, and consumer goods. BAEF also has a micro- and small-business loan program.

The micro-loan program, operated by the Nachala Foundation, a nonprofit organization managed by Opportunity International, provides loans of up to U.S. $20,000 although the average loan size is approximately U.S. $6,000. As of late 1998, Nachala has provided nearly 500 loans totaling more than U.S. $2.5 million (BAEF 1999b). Nachala also offers business training. The small-business loan program, also known as Kompass, is a cooperative program between BAEF and several local banks. Kompass provides loans to SMEs for up to three years to finance equipment, construction materials, and other capital investment needs. Loans range from U.S. $25,000 to U.S. $75,000. As of late 1998, Kompass has disbursed over 80 loans totaling approximately U.S. $4.6 million (BAEF 1999b).

Western NIS

In operation since June 1995, the Western NIS Enterprise Fund (WNISEF) had an initial capitalization of U.S. $150 million for its operations in Belarus, Moldova, and Ukraine. WNISEF provides SMEs equity capital and loans ranging from U.S. $750,000 to U.S. $7.5 million. WNISEF also has a small business loan fund (SBLF), capitalized at U.S. $5 million, that makes commercial loans ranging between U.S. $10,000 and U.S. $100,000 to small enterprises in Ukraine. Although SBLF initially had problems disbursing loans because it did not have a banking license, as of 1998, SBLF has disbursed loans worth approximately U.S. $24 million to more than 50 small enterprises. The majority of SBLF's financial support has gone to firms operating in agribusiness, construction, and furniture manufacturing (Reintsma and Tarnoff 1996). Additionally, WNISEF provides post-investment support including assistance in business planning and corporate governance, business training, senior management recruiting, and management information systems (WNISEF 1999).

Business Support Centers (BSCs)

Like enterprise funds and business incubators, BSCs offer a variety of services to stimulate enterprise development and growth. These services generally include access to credit and financing, business training, and information services. However, unlike enterprise funds and business incubators, BSCs are not modeled after venture capital management companies. BSCs do not usually invest in other firms. Rather, BSCs are simply institutions that provide business services to all types of firms, regardless of size or length of operation. Furthermore, unlike traditional business incubators, BSCs do not provide physical space for clients and therefore must rely on the income generated from their services to cover operating costs. Also, contrary to typical business incubators, BSCs do not have a selective entry process or require firms to "graduate" after a certain point. BSCs provide services for as long as clients can pay for the services. BSCs have also been referred to as business support organizations (BSOs) and business support institutions (BSIs), but for the purpose of clarity, the term BSC will be used to refer to all three types of organizations. The activities and impact of some centers in selected E&E countries follow.

<u>Moldova and Ukraine</u>

Under the NEWBIZNET project, a program to support SME development in Moldova and Ukraine, USAID has provided funding to nine pre-existing BSCs. Eight of these BSCs are in Ukraine, and one is in Moldova. The project began in September 1994 and has been managed by Development Alternatives, Inc. Since October 1995, these BSCs have generated over U.S. $1.5 million in revenue and provided services to over 17,000 clients (USAID 1999). Additionally, the consulting departments of these BSCs have assisted over 50 clients in securing financing equivalent to over U.S. $25 million (USAID 1999). Nevertheless, according to a 1996 evaluation, this project has produced mixed results (Houghton 1996). On the one hand, business education and training was an activity that attracted a lot of client interest, particularly in the Lviv and Odessa BSCs. For example, as of August 1996, the BSC in Lviv had attracted over 480 participants in courses offered by trainers from Germany, the United States, and the United Kingdom.

The Odessa BSC had over 440 participants in their training courses, generating a profit of approximately U.S. $28,000 in training revenues. On the other hand, some of the centers were unable to provide effective business advisory services, especially in regard to business planning, due not only to the lack of skills by center staff but also to the business information network (BIN)—a database consisting of legislation on SMEs and general information on local firms—not being functional in certain cases. In Odessa, for instance, the BSC had no full-time person responsible for managing the BIN. Furthermore, earning profits at cost-recovery and financial sustainability levels has been problematic, and the performance and impact of the centers has been constrained by the lack of available credit for SMEs (Houghton 1996). On this last point, SMEs in Moldova and Ukraine have difficulty gaining access to credit because banks in these countries, and in many others, prefer short-term lending and providing credit to larger enterprises, rather than SMEs. The high interest rates offered by banks, along with burdensome collateral requirements, also limits the ability of many SMEs to gain access to loans.

Macedonia

The Macedonia Business Resource Center (MBRC), operated by Crimson Capital, was established in 1995 to help accelerate the development and growth of private enterprises through restructuring and technical assistance. Assistance is given to already privatized firms to improve their financial stability, profitability, operations, management, and ability to raise capital and attract joint venture partners. Since its inception the MBRC has conducted over 240 workshops to nearly 4,100 trainees, provided services to over 250 clients, and has graduated more than 200 businesses (Crimson Capital 1999). Furthermore, the center has a training component for both staff and clients in the areas of business planning and financial management. The training component has been an essential service of the center because many clients lack the business skills to operate effectively on their own. Although it has gradually built up acceptance from the business community and government, the center has been constrained by an environment in which available financing, especially for SMEs, is lacking; businesspeople trained in modern business methods are rare; and progress in legal and regulatory reforms has been slow. Achieving financial self-sustainability appears unlikely although it does have the opportunity to attract funding from sources outside of USAID. A number of other donors, development banks, and NGOs have expressed interest in collaborating with the MBRC (Godden 1998).

Russia

The New Business Development Program (NBDP), established by USAID in 1993, has been implemented and managed by Deloitte Touche Tohmatsu. The program created BSCs in eight cities. Similar to the BSCs in Moldova and Ukraine, the centers in Russia were created to provide direct assistance to entrepreneurs, help build business infrastructure, improve the environment for small business development, build government support for SME development, and provide training to business owners (Astrakhan et al. 1999). While the size and activities of the BSCs vary with each location, typical services include networking, development of financial linkages, enhancement of ability to attract and manage capital, information services (access to libraries, databases, etc.), and training.

The impact of these organizations included the formation of strong support networks between the private sector, financial intermediaries, local government, and business associations; start-up of 2,600 new businesses, leading to the creation of approximately 37,000 jobs; formation of over 50 new business and professional associations; and provision of over 180 new training programs. In a survey of NBDP clients, since receiving services from these BSCs, 75 percent witnessed an increase in production, 81 percent revealed increased sales, and 82 percent reported an increase in net profits (Astrakhan et al. 1999). The BSCs have also been self-sustaining since the end of USAID funding in March 1997, although the degree of success in achieving self-sustainability varied from center to center. Self-sustainability was not achieved without some significant changes in operating procedures. The BSCs can no longer provide services that are not fully cost-recoverable, many BSCs have stopped direct training activities altogether because of the high costs involved, the number of client target groups and diversity of clientele has decreased, and many of the BSCs had to streamline their organizational structures (Astrakhan et al. 1999).

Slovak Republic

The Slovak Business and Banking Advisory Center (SBBAC) is an organization that provides some of the same services as the BSCs mentioned above, but it was created to serve enterprises and financial institutions. SBBAC, established in 1995 by USAID, evolved from the Slovak Enterprise Restructuring Center (SERC). The SERC was designed to assist medium-sized private enterprises facing severe financial and commercial difficulties. The SBBAC was created to develop banks and enterprises through consulting and management training. Although not necessarily targeting SMEs, SBBAC is a relevant case nonetheless due to the success of its training and local capacity building efforts. Some of the services SBBAC offered to its clients included a training institute, the dissemination and publication of a management journal, dissemination and documentation of SBBAC's methodologies, and consulting practices. SBBAC charged and collected fees from its clients in order to cover operating costs.

Overall, SBBAC has had a significant impact on its clients, leading to increased sales and cash flow, decreased labor costs, and lower costs per unit of sales (Edgerly and Exton-Smith 1998). Some specific indicators of this impact are that 71 firms participated in restructuring and performance improvement projects, resulting in an increased operating cash flow of U.S. $29 million per year; eight consulting partners graduated from the capacity building program, and now consulting projects are being sold independently by firms trained by SBBAC; over 1,500 managers were trained in accounting, marketing, and product management; a business journal was published with over 200 subscribers and distributed through more than 500 various media channels (Edgerly and Exton-Smith 1998).

Business Incubators

Although similar to BSCs in terms of the services they provide, business incubators are unique in that they are controlled work environments in which clientele manage their business operations within the incubator itself. Incubators are designed to foster the growth and development of new and emerging SMEs, which would likely falter without the services that incubators can provide, into self-sustaining enterprises with high growth potential. BSCs, on the other hand, typically work with existing businesses. One key to any incubator's success is to carefully select those firms with the potential to grow. Otherwise, the incubator will not gain any return on its investment.

Characteristics of typical incubators include the following:

- Provision of designated office space for each client (usually between 10 and 30 at a time) within the incubator itself

- Provision of facilities necessary to operate a business; these facilities include access to communication, administrative support, and office equipment

- Access to professional services relating to business planning, and legal and financial assistance

- Affordable rents and fees for clients

- Networking opportunities with Western business professionals

- Access to a small management team who provide training and other business development services

Two other aspects of incubators are vital to understanding their proper function (Lalkaka and Bishop 1996). The first is that clients of the incubator should be able to “graduate” after three to four years of residence at the incubator. Second, incubators should be run as businesses themselves and need to focus efforts at becoming financially self-sustainable. As discussed in the sections on enterprise funds and BSCs, achieving financial sustainability is a major challenge for organizations that provide business development services.

The performance and impact of incubators depends upon several factors, including a market for the services that incubators provide; commitment from sponsors, including initial financial support from governments and/or donors; a skilled and experienced management team; a legal, regulatory, and policy environment conducive to enterprise development; and basic business infrastructure (telecommunications and transportation systems, utilities, skilled labor). Lastly, the impact of business incubators can be measured by several indicators. These include:

- Type and number of new businesses created (i.e., survival rate as measured by the number of firms incubated vs. the number discontinued)

- Number of direct jobs created

- Contribution of incubator to the development of a business culture

- Impact on clients/tenants (variety of services offered, number of tenants, occupancy rates)

- Sustainability of incubator; ability to achieve financial self-sufficiency (Lalkaka and Bishop 1996)

<u>Russia</u>

USAID has funded a virtual incubator in Russia known as The International Business and Technology Incubator (IBTI). This incubator provides services to new technology-based firms at research and development (R&D) institutes (Krimgold and Brett 1997). USAID funding of the incubator, during the time period between October 1994 and September 1997, amounted to approximately U.S. $2.5 million. The disbursement of the USAID funds occurred in two phases. In the initial start-up phase, seed funding was provided to new technology-based firms while the second phase entailed providing funds to develop those firms with the greatest potential of growth and sustainability. IBTI provided seed grants to businesses to help get them started. If the businesses were successful, they would have to reimburse IBTI for the grants.

Unfortunately, indicators of IBTI's impact on job creation and business formation and development were not available. Instead, other indicators measuring impact are available. As of 1997, 22 cities and regions were under the IBTI network, 676 new entrepreneurs had received training in technology business development, and IBTI had begun to seek out and receive funding from non-USAID sources. A former project manager for IBTI believes IBTI was successful at leveraging funds because it gathered financial support from a number of sources and it charged clients for its services (Brett 1999). Lastly, according to a recent evaluation, IBTI has achieved the goals it set: to create and support the formation of technology-based SMEs, to create job opportunities, and to develop a self-sustainable model (Krimgold and Brett 1997).

Another USAID-funded incubator in Russia is the Volkhov International Business Incubator (VBI). Founded in 1995 by the city of Volkhov and the Alliance of American and Russian Women (AARW), VBI was tasked with supporting SME development with a particular focus on promoting women-owned or -managed enterprises. It was supported through USAID/Russia's New Business Development Program (NBDP). The goals of the VBI were to create a sustainable incubator to offer services for 10–15 new tenants at a time, offer support to firms in which at least 60 percent were women-owned, develop credit mechanisms to disburse loans and provide leases, establish an educational institute to provide business training, develop trained business consultants, and eventually transfer the incubator to Russian management (Schmertz et al. 1998).

Since 1996, VBI has been able to serve 17 clients, although 5 have recently graduated, by providing office space, consulting, training, administrative support, and access to credit. Through VBI's services, almost 100 new businesses have been established, leading to the creation of approximately 360 new jobs. VBI has provided over 140 training seminars to approximately 1,700 trainees. According to recent VBI data, 80 percent of these trainees were women (Schmertz 1999b). VBI charges fees for training and other services in order to sustain itself. Additionally, it continues to support women-owned businesses through offering a woman's business empowerment program. According to a report by the incubator's founder, VBI has played a leading role in establishing the first independent nonprofit organization in Volkhov, it is an important factor in lobbying government support for SME development, and the transition to a Russian-led management structure has gone smoothly (Schmertz 1998). It also publishes a manual on how to establish and manage a small business and is the only organization in the Leningrad oblast to offer leases (e.g., for equipment) to small businesses. In total, VBI has provided 60 leases for equipment (Schmertz 1999b).

These successes notwithstanding, VBI has faced some difficult challenges. Achieving financial self-sufficiency has been an arduous task, given that VBI is located in an economically depressed area. In fact, VBI often had to cut expenses (reduce salaries, layoffs) to live within its means and as of late 1998/early 1999, it was approximately 75 percent self-sustainable (Schmertz 1999a). The long-term financial sustainability of VBI is difficult to determine given Russia's recent economic turmoil. Additionally, the market for VBI services is relatively small. The initial client pool was not big enough to generate revenue to adequately cover operating expenses. VBI now serves a larger geographic area in order to generate more revenue. VBI has also had to operate in an environment with a burdensome tax structure and lack of government support.

Although a few of VBI's services, particularly the leasing program, have been successful, some USAID officials question the cost-effectiveness and long-term sustainability of such organizations. According to Kevin Armstrong (1999), director of the Economic Reform Office for USAID/Russia, “incubators can accomplish a great deal, but they require large amounts of start-up funding and long-term sustainability is difficult to achieve. Providing a sizeable amount of funding, to incubators does not represent the most efficient way of allocating USAID’s diminishing budget resources.” He cites an example of how in 1994 USAID entered into a three-year, U.S. $2 million cooperative agreement with Opportunity International (OI) to implement a business support program in Nizhny Novgorod that contained three components similar to a USAID/Russia-funded incubator program. By the end of the agreement, the OI program had provided 2,900 loans and trained 13,450 people. By comparison, the incubator program provided only 93 loans/leases and trained only 5,850 people. The OI program has also become fully sustainable while the incubator program has not.

Overall, Armstrong avers that “our [USAID/Russia’s] experience has shown that incubators are cost intensive and cannot compete with regular business support institutions in creating and sustaining enterprises and jobs. Incubators require more resources to run and maintain. The overhead costs are higher. A business support institution is more flexible and can work with a wide range of existing businesses and new businesses to provide the assistance necessary to get goods and services to the marketplace.” As a result, USAID/Russia now targets its support toward “proven” training programs and organizations that provide credit to MSMEs.

Ukraine[2]

The Business Incubator Development (BID) program in Ukraine is operated by Loyola College and was established in September 1997. The program seeks to create and maintain business incubators to foster the growth and development of SMEs. Loyola manages an “incubator without walls,” known as the Center for Innovation Development (CID), in Kyiv and a physical incubator, known as Kharkiv Technology Incubator (KTI), in Kharkiv. These incubators were set up to provide technical assistance, training, access to finance, and other services. As of September 1999, the loan program has not been implemented by either incubator, although KTI has an agreement with a local credit union to provide loans to KTI’s clients. To date, this credit union has disbursed loans worth approximately U.S. $5,000 to seven clients. Both incubators cater to the technology and light manufacturing sectors, with an emphasis on supporting women-owned or -managed enterprises. The program provides assistance in business planning, gaining access to financing and commercial ventures, seeking and negotiating licensing opportunities, and exporting technology-related products. Training is offered in marketing, finance, management, and business planning.

Although both CID and KTI hail themselves as incubators, they do not provide support to start-up companies. Rather, they provide services to existing businesses. Furthermore, contrary to typical incubators, CID does not provide physical space to its clients. It simply provides training

[2] For a more in-depth discussion of the USAID-funded incubator program in Ukraine, see the forthcoming assessment by Lalkaka and Zasiadly.

services, including business courses taught by professors from the International Management Institute (IMI), located within the same building as the CID office. Similarly, KTI also offers training services, but unlike CID it provides space and access to office equipment and the Internet for approximately five companies.

In terms of the impact of CID's and KTI's services on job creation and income generation, very little measurement of these indicators has been done. Instead, according to George Gamota (1999), the BID program's in-country director, the Kyiv incubator has assisted approximately 210 companies with over 2,300 employees; taught over 500 students; developed 40 business plans; and has received payment from 75 percent of its clients for training services. He also states that the incubator in Kharkiv has assisted over 160 firms with nearly 1,800 employees, taught approximately 270 students, developed almost 30 business plans, and has received payment from 50 percent of its clients for training services.

According to Duane Shelton and Robert Margenthaler (1999), two of the BID program's U.S.-based directors, one of the potential challenges to long-term success of this program is the absence of strong political support. Such support is needed from local politicians or governmental organizations who understand the potential rewards of the development of SMEs, who are committed to the goals of the incubator, and who can provide some financial and/or managerial support to the growth of the incubator. Local administrations in Ukraine typically lack the capacity to provide such support, and it is unlikely that such support will emerge before USAID funding of the BID program ends in March 2000.

In addition to CID and KTI, another incubator is in operation in Lviv. This incubator, known as the Counterpart Meta Center (CMC), is run by Counterpart International and has been funded by USAID since 1997. The CMC disburses loans, provides consulting, offers training programs, and provides space to approximately 12 tenants. Similar to CID and KTI, CMC only provides support to existing businesses.

The main strength of CMC lies in its loan program. In fact, approximately 70 percent of its income is derived from the interest generated from loans and fees charged to loan recipients. The remaining 30 percent of CMC's revenues are derived from rents and fees for training services. Between August 1998 and August 1999, 18 loans, valued at U.S. $122,904, were disbursed. During this period, the average loan size was U.S. $6,828; the average term of each loan was 10.3 months. The appeal of CMC loans is an interest rate (57.5 percent) that is significantly lower than the rates (approximately 75 percent) of most commercial banks.

CMC expects to be self-sustaining by the time USAID funding ends in October 2000. Some evidence exists to support this claim. For instance, income has been rising in recent quarters—from U.S. $3,344 in third quarter 1998 to U.S. $13,244 in third quarter 1999—and based on CMC projections, is expected to rise to U.S. $29,549 in third quarter 2000. CMC also claims to have been successful at creating jobs. CMC data indicates that 48 jobs have been created and 236 have been "sustained" through its services, although it is very difficult to determine the link between CMC's services and job sustainability. Just because some clients did not lose their jobs after receiving services from CMC does not necessarily imply that CMC sustained their jobs.

IV. CONCLUSION

Lessons Learned

- *An enabling environment conducive to private sector development is a precondition for the delivery of effective business development services.* Such an environment consists of macroeconomic and political stability; political commitment, from both the national and local levels, to the privatization process; local government support of business development service providers; a legal framework that enforces laws regarding contracts and property rights, as well as settles disputes; simplified business registration and licensing requirements; a tax system that is not overly burdensome; institutions that represent private sector interests; and the availability of finance to new or emerging firms.

- *Enterprise funds, BSCs, and business incubators must have a market for their services to become sustainable.* If demand does not exist for business support services, these organizations will likely fail. In many cases, the legal and policy environment hinders business formation and development. In these instances, business support programs have a difficult time serving their intended clientele. One way to measure if market demand exists for business development services is to conduct a feasibility study of the proposed location of the service provider prior to the implementation of the project.

- *Achieving financial self-sustainability is a difficult but necessary objective of business development service projects if they are to achieve long-term success.* Since donor funding is usually only available in the initial phase of these support programs, these programs must eventually find alternative sources of funding. These alternative sources can originate from fees for services, although these fees do not always cover operating costs, or from other donors or organizations.

- *The process of achieving financial self-sustainability has potential drawbacks.* In the case of Russia's New Business Development Program, several BSCs had to cut services that were not fully cost-recoverable and had to scale back the number of client target groups. Many also had to streamline their organizational structures. This type of scaling back seriously impedes the development of the SME sector, a sector that is usually constrained by lack of resources and policy support to begin with. As a result, donors should recognize the potential for some service providers, in order to achieve sustainability, to scale back their services to SMEs and instead expand services to larger enterprises. These larger firms are financially stronger than SMEs and hence better equipped to pay for services.

- *Enterprise funds, BSCs, and business incubators require management personnel with an appropriate level of business experience and skills to operate the organizations efficiently.* Since these organizations are new businesses in themselves, they require a skilled and experienced management staff. Usually, management of these organizations is staffed by expatriates skilled in Western business practices. However, it is a goal of many of these organizations to eventually transfer management of the organization over to local hands. As a result, local capacity building through business education and training programs is necessary before transferring management authority to local hands.

By definition, enterprise funds, BSCs, and business incubators differ in organizational structure, level of capitalization, and service delivery. In practice, however, they offer similar services. All three types of business development service providers can offer technical assistance, in terms of business advisory, training, and related services, as well as access to credit and financing. As a result, practitioners should be aware of the impact and performance of each type of program mentioned in this paper in order to determine which type of service is most appropriate to the environment he/she is working in. Furthermore, as already discussed, USAID experience with enterprise development in the E&E region has revealed numerous economic, political, and financial obstacles to creating the appropriate environment for SMEs to succeed. USAID should continue, if not increase, its efforts at and resources for creating this enabling environment. Without a policy environment conducive to private sector development, providing the types of business development services discussed in this paper will be worthless.

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